RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**
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April 21, DJIA 812.80; PTI 774; A-D Ratio –19.04
April 28, DJIA 837.32; PTI 791; A-D Ratio –18.69

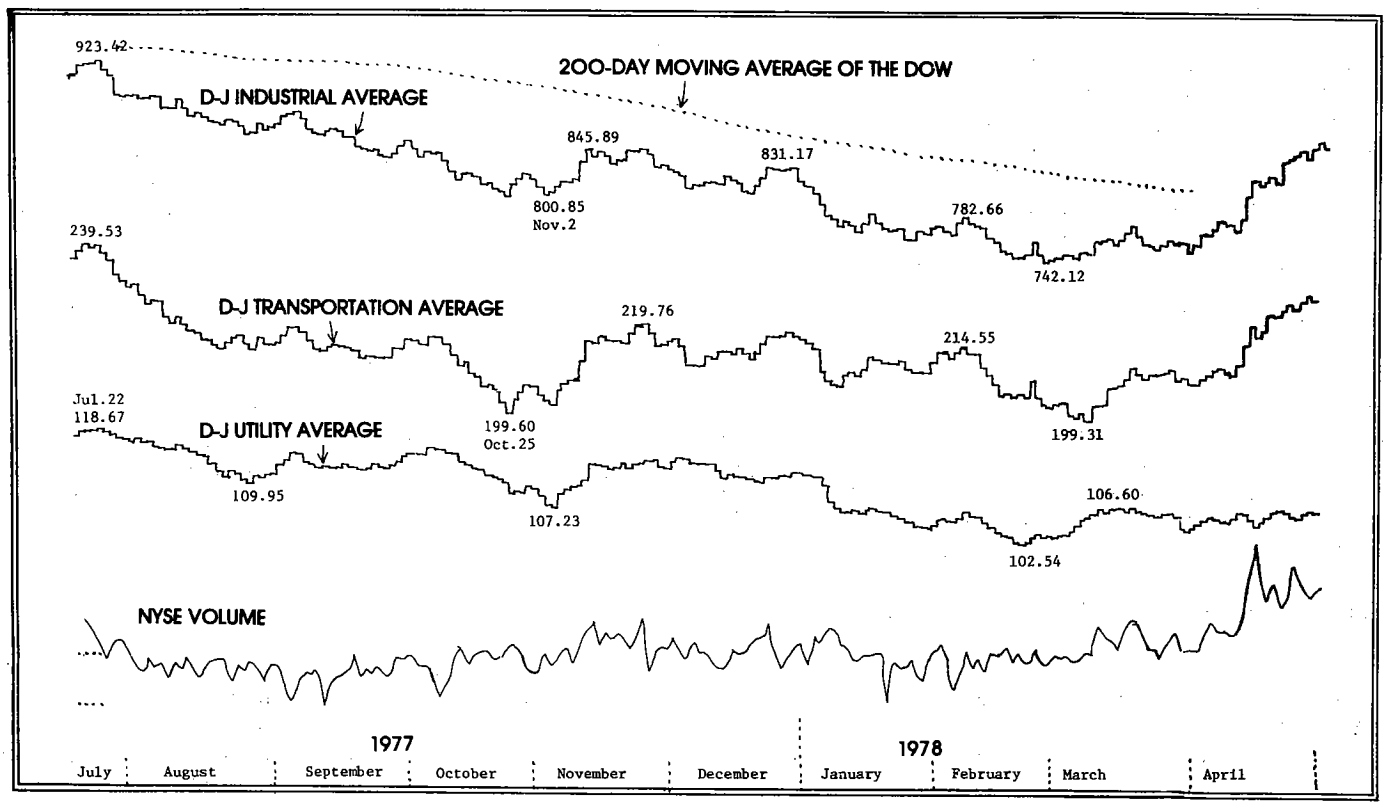
PRIMARY TREND: When, following an extended movement in the stock market, prices suddenly move forcefully in the opposite direction, experienced investors always ask one question: "Has the primary trend reversed direction?" That is always the single overriding question, the answer to which can make or break Presidents, Congressmen, governments, companies and investors.

In my considered opinion (and I went into this in the last Letter) we have been witnessing a violent "spear-point rally" within a continuing primary bear market. The upward force of the rally was a function of a variety of factors. Among these were: (1) Many option writers were caught on the wrong side of the market. Many puts were outstanding as were a large number of "naked options" (options in which the writer did not own the stock). (2) Many fund managers and institutional managers were caught with (for them) large quantities of cash. Terrified lest the market should mount a major move without them, they poured into the market. (3) A big short interest grew even bigger (by six million shares) just prior to the rally. These shorts panicked to cover as the market surged higher. (4) Traders, tired of months of inactivity, poured into the market when they perceived the lopsided technical position and the dramatic short squeeze. (5) Lastly, foreigners, believing that the dollar had at last "turned the corner," threw in huge sums of money in an effort to "catch the bottom."

As far as I am concerned, the true elements of a bear market bottom were missing at the 742 Dow lows. For instance, instead of a greatly reduced margin account, which is characteristic of a bear market bottom, margin debt on the NYSE all during 1978 has been at record levels. Next the monetary picture was bearish, as identified by the authoritative *Bank Credit Analyst*. Pessimism was mild, but NOT bearish as it always is at major bear market bottoms. Had sentiment been bearish enough, some of my many technical indices would have signalled an over-sold condition for the market. But I did not have such a reading at any time during 1977 or 1978. Bonds were weak during the February to March period, a situation almost never seen at a major bear market bottom (the bonds, which reflect the monetary situation, are always in a rising trend at major bear market lows).

I could go on and on, but what I'm trying to do is impress on subscribers my conviction that the market, during the first quarter of 1978, was neither fully oversold nor at a major bottom. For this reason, I believe that a primary bear market continues in force. If that's the case, then in due time the Dow and most stocks will register new lows.

In order to function in the investment business, you must have some **consistent method** of operation. My own method has been to attempt to stay in harmony with the primary trend of the market. This means being fully invested during primary bull markets and being in cash or equivalents during primary bear markets.Any other course (and there are many of them) constitutes some form of borderline speculation or outright gambling. Ultimately, the borderline speculator and the gambler will lose in the stock market. Their demise may take a month



or ten years, but I have seen too many of them lose their money to make me want to follow their example.

A corollary of my method of operating in the market is this: an investor (or trader) should never move into a poor risk-reward situation. In other words, he should avoid a situation where there is a chance of a minor potential gain and a large potential loss. This means missing (avoiding) some potentially profitable situations. It also means buying only when the odds are as favorable as possible for the buyer. The safest and most advantageous time to buy stocks is always at an **identifiable** market bottom. These are the bottoms which produce important oversold criteria. Such bottoms usually come once (occasionally twice) a year. Strangely, unaccountably, we have not seen such a bottom since late 1976. Because I don't like to gamble (nor do I advocate gambling for my subscribers), I will wait patiently for the next oversold bottom. It may take a month, six months, a year, but I will wait.

I'll wait because I don't see the point in taking hard-earned after-tax cash and throwing it into a market situation which appears frothy and temporary. Remember, with the current tax structure it makes little sense to take a thousand dollars (which may represent two thousand or more in pre-tax earnings or income), and with that thousand try to make a risky taxable two hundred dollars. It does make sense to take the thousand and buy stocks at an identifiable market bottom where (1)you have a chance for a major profit, and (2) you have a chance for long-term capital gains.

So I'll say it again: we haven't seen an oversold market this year. Yet it is well to remember that oversold conditions have **preceded** every major, lasting stock market advance of which I have any record–going back to the 1930's.

So much for the market conditions that I term oversold. Now I want to talk about being on the right side of the great primary trend of the market.

Probably the most dramatic and instructive example of "riding the primary trend" that I have ever seen was the late E. George Schaefer's extraordinary performance during the period of 1949 to 1966. Schaefer, the great Dow Theorist who began his advisory in mid-1948, called the start of the bull market to the day–on June 13, 1949. (I still have that report). Schaefer called for a fully invested position from that point on. During 1953 a rather vicious secondary reaction shook out many of the original believers, but Schaefer, preaching the power of the primary trend, simply told his readers to "buy more" at the bottom of the reaction.

Again during the 1956-57 reaction Schaefer insisted on the same policy. But the 1957 drop was persistent and terrifying, and Schaefer's "buy more" policy seemed suicidal at the time. But the market turned up in late 1957 and by late 1958 (still fully committed to stocks) Schaefer's portfolios hit new highs. Again during the searing correction of 1962 Schaefer told his readers to depend on the power of the ongoing primary bull trend to build their fortunes. By 1963-64 it was clear that Schaefer had been proven correct again.

In February, 1966, Schaefer called the end of the great bull market, sold out all his common stocks, and took a large position in gold shares. In conversations I had with Schaefer during 1966 he told me that he expected the oncoming bear market to be a "long one, and a hard one." He expected the Dow to end its bear market decline in the 150 to 350 range.

Unlike Schaefer, Robert Rhea (the pioneering Dow Theory genius of the 1930's) attempted to trade the secondary trends. "Secondary reactions," wrote Rhea, "are as necessary to the stock market as safety valves are to steam boilers." In another report he wrote (quoting Hamilton), "It is a tried and true rule, which will help to guide us in studying the secondary movements, that the secondary movements in the broad market are abrupt, while the resumption of the primary movement is appreciably slower."

I've had a policy ever since I began this publication of resisting the temptation to play the movements against the primary trend. Thus, during 1957 and 1960 and 1962 I did not advocate shorting the market, even though shorts put out at the right time (in retrospect) would have been profitable. However, I did move out of the market during those bull market reactions, and thus subscribers were spared potentially large paper losses. Of course, the danger in moving out of an ongoing primary bull market is that you may not get back in (in a fully invested position) at the turn. This was Schaefer's argument, and it is the reason why he used reactions to buy more, rather than attempt to trade in and out of the reactions.

In my experience, buying stock for a bear market rally is as chancy as putting out shorts in a bull market reaction. Mind you, I've seen many traders successfully jump into a bear market rally, but such action takes nerve, luck and a willingness to take losses immediately if the rally "doesn't get off the ground." For those reasons I've developed a procedure over the years, and the procedure is as follows: I never buy stock in any kind of a market unless I (1) am buying at an important **over-sold** area or (2) unless I am buying in a dull decline during a bull market. This policy has stood me in good stead over the years. It has resulted in a minimum of losses. I go on the premise that it is too bad when I miss a good advance, but it is a disaster if I ride through a major decline.

The rally which began from the February 28 Dow low was one that was "predicted" by a few astute and a few other lucky analysts. But nobody predicted the record-breaking volume of the rally. The fact is that the Dow lost 272 points from its 1976 high to its 1978 low. The rally in 1978 gained 92 points of the bear market which is only 33%. It was the volume that was spectacular, not the price movement.

I often think back over my market performance and ask myself, "Russell, if you could change something you wrote, what would you change?" I think I would have underscored the following thought: the market had gone down from the September, 1976 high to the February, 1978 low, a period of 17 months with only a single rally of 5%. This was a record-breaking poor performance. After such a long, uninterrupted decline, it was logical to think that the first decent bear rally would also bring in some kind of record-breaking statistics.

In Letter 723, March 1, 1978, I wrote that a rally might be expected around the 744 Dow level. Here's what I said: "The Dow 744 level could be significant enough to set off an 'impressive rally', but I believe such a rally would represent a trap for the bulls." The rally which followed was impressive,

and it was, of course, one for the record book. And I remember Robert Rhea writing that long, dull movements (in either direction) are usually followed by violent, exciting movements in the opposite direction. So, I conclude, I might have expected something of the sort after the 17-month dragging decline of 1976-78.

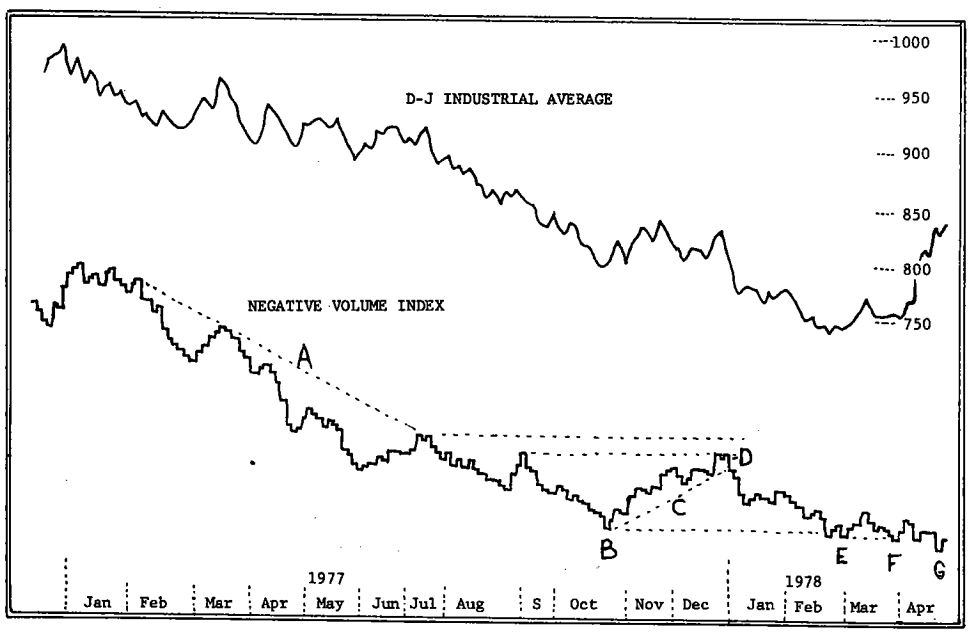
CONTRACTING VOLUME INDEX: It was during the 1940's (it may have been earlier) that Paul Dysart Sr. did a good deal of his pioneering technical market work. His discoveries were published in *Trendways*, his market advisory service. I followed a good many of the Dysart indicators until the time of his death some years ago.

Dysart had a theory about breadth, volume and the market which I have always felt was not only interesting but valid. Dysart observed that the "big money," the informed money, preferred to operate in the market during periods of relative *quiet*. Conversely, the public (uninformed money) was attracted to active markets and tended to operate in *active* markets.

From this basic concept Dysart developed two indices. They were quite simple. One index consisted of the advance-decline differential on days when market volume expanded over the previous day. The other index was the A-D differential on days when volume contracted from the previous day's volume. Both indices were plotted on a continuous basis so that each expanding day's A-D differential was added to the last expanding day's differential.

The expanding-volume index was called the positive volume index and the contracting volume index was termed the negative volume index. Of the two, Dysart felt that the *negative-volume index was by far the more important* because this index showed what was happening with informed money, the money that **leads** the market.

It should be remembered that the negative (contracting) volume index is composed of A-D differentials which are entered only on days of contracting volume. Thus, it is possible to have say a single negative volume entry in five or six trading days on the NYSE–or it is possible to have five entries on five consecutive trading days. It all depends on volume trends.



I am including my chart of the negative volume index covering the period of 1977 and 1978 to date. This interesting study shows us one basic and fundamental action. It shows us whether prices are supported or not *following* a market advance. For instance, after a rally, the market volume almost always simmers down, contracts. In a technically strong market, prices tend to *hold* their gains following a rally. But during a weak market (or a bear market) prices do not hold their gains after a rally, and in such cases the price level will recede (following the rally) even as volume contracts. This is what the negative volume index shows us–clearly and often dramatically.

On the simplest level, a series of successive lows in negative volume (NV) implies that distribution is occurring. A rally peak in NV, a large decline and then a new and higher rally peak is considered an important bull signal. Conversely, a low point, then a good rally and next a decline which carries below the preceding low point is considered a bear signal.

I have placed the Dow above the NV on the chart, and what we see here is a long series of declines in NV. The NV line dropped steadily (trendline A) from January, 1977 to the October low at point B on the chart. At B the NV produced its first good rally of the year (trendline C). At point D in December, 1977, NV exactly matched the previous September high but failed to better that earlier July high. If either the September high at D or the July high had been bettered, this would have been a strong bull signal.

Following the failure at point D, NV began to sag again. On February 28 (point E) a new low was recorded for the entire bear market. This constituted a bear signal and signified that prices were not being sustained, regardless of rallies. Then, on April 4 (point F) another new low was recorded. Finally, on April 27 (point G) the NV broke down badly as declines outnumbered advances by more than 600 as market volume receded. This cluster of NV bear signals does not bode well for breadth or the market in general. It is telling us that it takes huge, expanding volume to put prices up–but that prices fall easily and significantly when volume recedes.

Conclusion: The NV index is implying that breadth (i.e., the advance-decline ratio) is near the end of its run-up, and that something is seriously wrong with the breadth picture on this rally. For months breadth has been outperforming the Dow. I would now expect breadth to turn weaker than the Dow. A classic danger signal would be new recovery highs on the Dow unconfirmed by the A-D ratio.

BONDS, UTILITIES: One of the rules I've used with my own money is that I don't invest it in the stock market unless I have the trend of the two-widely-watched Dow Jones money-sensitive Averages with me. By "with me" I mean in a bullish trend. Over past history, when the monetary forces are bearish enough to move both the Bonds and Utilities into a declining trend, that same adverse pressure provides a bearish background for stocks. Conversely, if the monetary pressures are bullish enough to turn both of these indicators up, then the same monetary conditions form a bullish background for stocks.

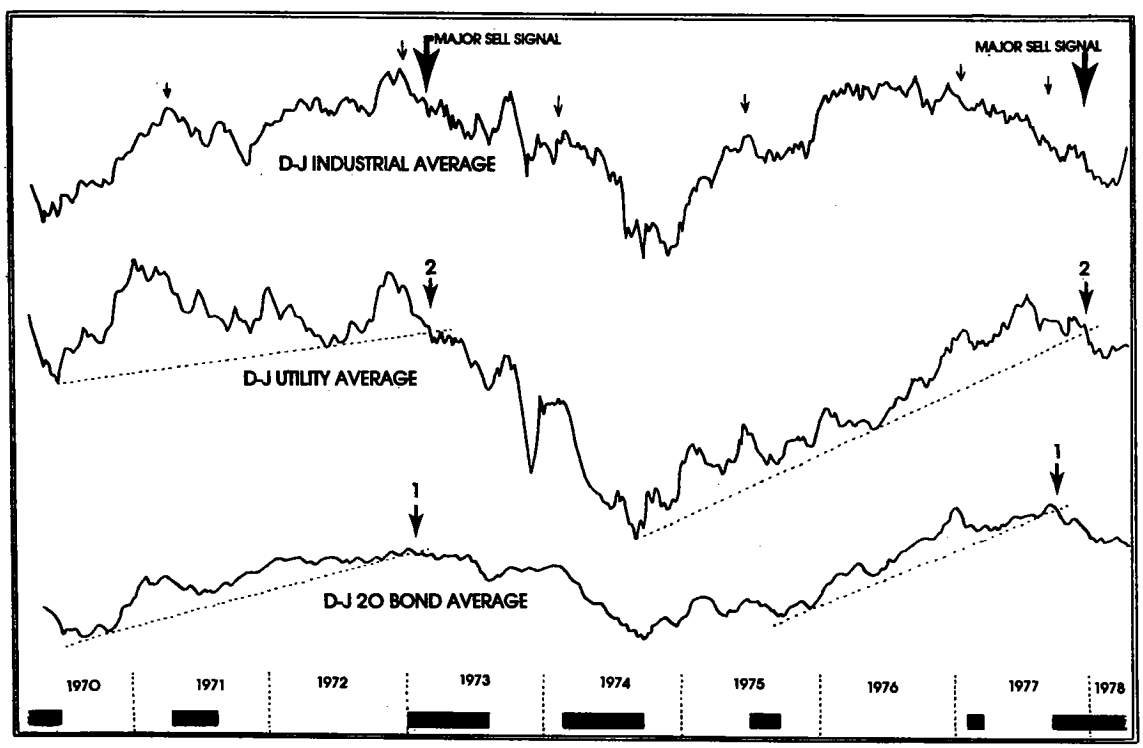
The reading of this graph is simple enough. The black bars at the bottom of the chart identify the areas where both the D-J Utility Average and the D-J 20-Bond Average were in bearish trends. The stock market action during those periods was uniformly bearish.

In early 1973 these two Averages gave what I termed a "major sell signal" in that they broke long rising trendlines (at the points marked 1 and 2 on the chart). This bearish action preceded the massive 1973-74 market collapse.

In late 1977 the Bond Average broke a two-year rising trendline. This is identified at point 1. At point 2 the Utility Average confirmed (early-1978) by breaking below its entire 1974-78 trendline. The inference was clear; the monetary background for stocks had turned bearish.

Most recently, the D-J Utility Average has been attempting to reverse its declining pattern. However, as you can see on the chart the Utility action is taking place below the trendline. Moreover, the rallying action in Utilities has been very unimpressive. Furthermore, the relative strength of the Utility Average has been poor.

The D-J 20-Bond Average has continued in its bear trend, having sunk to a new low of 88.95 as recently as May 1. Thus, the two Averages have not taken back their bearish reading of early 1978. At this point, I am watching carefully to see whether (1) the Utilities turn decisively down again, thereby following the bearish trend of the bonds, or (2) whether the bonds turn up, and start to agree with the rallying tendencies of the Utilities. It is sure that this divergent trend between Utilities and Bonds is not going to last too long. But unless Bonds turn up, I must classify the last trend (which was bearish) as remaining in force.



WHERE ARE WE? I've always said that on a deep level (consciously or unconsciously) the American people always get (1)the President and Congress they want, and (2) the President and Congress they deserve. I think Carter and the Congress fit the tenor of the times perfectly. The American people are still passive. They are still looking to the Government for handouts. They are still taking everything Washington dishes out. Americans sit quietly while the nation is taxed and bankrupted. They wait, and wait.

The fact is that Americans are not yet ready to stick their heads into that bucket of icy cold water, and they are not yet ready to give up the big spending party. I look at the situation this way: if Americans are ready by 1980 to "take the cure," to face reality, then Jimmy Carter and company and most of today's Congress won't stand a ghost of a chance of winning the elections. We'll see.

Richard Thomas, President of the First National Bank of Chicago said the following in a recent speech: "After a decade of being taxed and regulated into oblivion, capital is virtually on strike in the US . . . . A dollar of current income devoted to consumption is essentially taxed only once–when it is earned. A dollar devoted to investment is also taxed when earned, but then it is taxed again and again as it results in profits, dividends and capital gains. Our tax system is thus heavily biased in favor of immediate hand-to-mouth consumption and against providing the savings and investments that are the source of future growth."

As I see it, we have two immediate, titanic problems in this country. (1) The nation is living, existing on a massive debt system. People are geared to a level of consumption which is far **above** what they produce, and thus a rising debt level is an absolute necessity for a continuance of the US "life-style" as we know it. (2) On top of this, the Government Bureaucracy has become a monster, an octopus that is devouring everything in its path, the capital, the income, the savings, the will of the businessman, the desire to produce.

A number of longer term (secular) problems are also blowing in the wind. This nation, for centuries, has prospered on a tide of cheap energy, cheap labor, cheap raw materials, and unlimited geographical frontiers. NONE of these factors are in force today. But instead of facing the changes, this nation is continuing to enjoy the great "deficit" party.

Aside from the US policy of producing horrendous deficits and then compounding the cost of those deficits (via compounding interest rates), the US for the first time in its history

is losing its technical lead. This, to my mind, is very serious, and it should have far-reaching implications. One of the implications is that in time US exports will be even more adversely affected than they are now because Europe and Japan will be cutting into our shipments of technical equipment. I include these few news clips from recent articles I have read. And the story is clear. Europe and Japan are fast surpassing the US in "know how," and they may ultimately beat us in world markets. This, in my opinion, (even more than the oil picture) is a major negative for the dollar and for future US balance of payments. If you want to be cold about it, the whole picture as described above is simply a factor in the secular bear market that I believe we are now caught in.

'EMPIRE' ERODES

U.S. Slips as World Leader in Technology

BY ROBERT C. TOTH
Times Staff Writer

WASHINGTON—For decades, every new technology or its product seemed to have "Made in America" stamped on it, from instant copying and instant photography to advanced computers, nuclear reactors, oral contraceptives, synthetic fibers and jet airliners.

Things have changed. There is concern in the White House and Congress, in industry and universities, that the United States is losing its technological lead in at least some fields.

Losing the Lead?

Many Americans Fear The Economy's Ability To Compete Is Waning

Inflation, Quality of Imports Are Cited; Protectionism Stirs Debate by Panelists

People Confused, Frustrated

By Richard J. Levine
Staff Reporter of The Wall Street Journal

INDIANAPOLIS—Janice Phelps, a slim housewife with five children in this middle-American city, is convinced that U.S. economic power in the world is waning.

"We may still be No. 1, but I don't think we will be much longer," the 43-year-old former teacher says. "The Common Market, Japan, Russia, all areas of the world are catching up. And I think our own inflation is causing this. It's no longer economical for us to produce anything; it costs too much."

Dan Homan, a soft-spoken self-employed salesman of industrial fasteners, also is worried. The Japanese, he says, "came over

It bothers me to say this, but behind most of the above stated factors lie the great tide of "new liberalism in America." It bothers me to say it because I was raised in NYC by a liberal family, went to "progressive" schools and a progressive university (NYU). But in my opinion the tide of liberalism has turned into a tide of destruction. I have never seen it expressed better than in an editorial (April 27) in the WSJ.

> We have seen American liberalism degenerate from a coherent vision, one which tried to improve individual lives by increasing federal power, into a gaggle of contradictory and competing claims from consumerism to the rights of the obese; we've finally got an administration that begins to reflect this incoherence. We've seen the same liberalism turn on itself in self-contempt for the loss of Vietnam and begin to argue that we should get out of the way of the march of history; now we see this argument dominating U.S. foreign policy and turning our human rights initiatives into little more than an embarrassment.

GOLD, MONEY: The tide of red ink keeps rolling in. The US posted a record $20 billion trade deficit during the first quarter. For the month of March, the US ran up a $15 billion budget deficit. The US budget deficit is now rocketing at an astounding rate of almost $2 billion a week. With an increasing amount of the entire US debt moving into the shorter-term market and with interest rates rising across the board, the nation is moving ever closer to what I call "the point of no return." And as I've said before, the country is now in the position of "inflate or die." There's no pulling back, there's no standing still.

"Why can't we cool it?" I'm asked. The answer: because the US is running up the down-escalator, and if we try to stand still, the rising debt structure and the interest on the debt (now over $40 billion for the Federal) will eat the money markets up alive. For that reason, the debt of the nation has become a "cancer," a parasitic organism that has taken off on a **life of its own.**

Furthermore, this process is being duplicated in almost every nation in the civilized world, from Australia to Canada, from Spain to Britain to France. I figure the total federal budget deficits for the 11 leading western nations ran about $600 billion in the past four years! Thus,the world (and the US in particular) is drowning in an ocean of fiat paper.

Incredibly, faith continues in paper. Less faith than before, it's true, but people still have faith in paper and politicians. Thus, gold's time has not yet arrived, but it is drawing ever-closer. And this is the reason I have consistently treated gold, not as a speculation, but as **insurance** against the inevitable collapse of paper currencies.

"But why will paper cave in?" you ask. And the answer is at least part of an ironic, emerging scenario. The US is finally turning to concern about the dollar. A well meaning Fed Chairman Miller is starting to put the clamps on the money market. We see this almost daily in the Fed figures and in the sinking bond markets.

In the meantime, prices of everything are moving higher, from houses to autos, from meats to restaurant meals. The consumer is starting to feel the pinch, and badly so. He's going to be forced to cut back on spending. This together with corporate financing problems (a coming mad rush for money) could bring on a recession during the second half of 1978. With the Fed belatedly bolstering the dollar through higher interest rates, I believe the coming crunch in the money markets is going to be something to behold. The net result will be surging interest rates, a collapse in mortgage availability and auto financing capabilities, and a recession. Next comes that inevitable Government and Fed response—a reversing of the money market gears.

This reversal will have to be tremendous in order to even begin to turn the economy around. By that I mean that huge infusions of money will have to be put into the system. When that happens, interest rates may or may not come down but gold should make its move. And that move should be a big one.

This sets up the opportunity for (1) very advantageous purchases of bonds, and (2) profits in gold. And that's what I see coming up between now and probably the end of the year.

My chart of gold and the gold averages (see page 6) is now showing a dramatic divergence. The gold stock average has broken below its November low, but the bullion price has held well above that point. Such divergences in the past have frequently led to important reversals, and such a reversal may be in the process of developing now.

On my weekly arithmetic chart of gold (page 6, bottom), I have labeled the rallies and declines in Elliott Wave terms. Thus, I believe we are in a large A-B-C-D-E Elliott bull market in gold Wave one (sub-divided into 5 smaller legs) carried to March 1977. The correction to point B ended in June, 1977. A new wave to C sub-divided into 5 smaller legs.

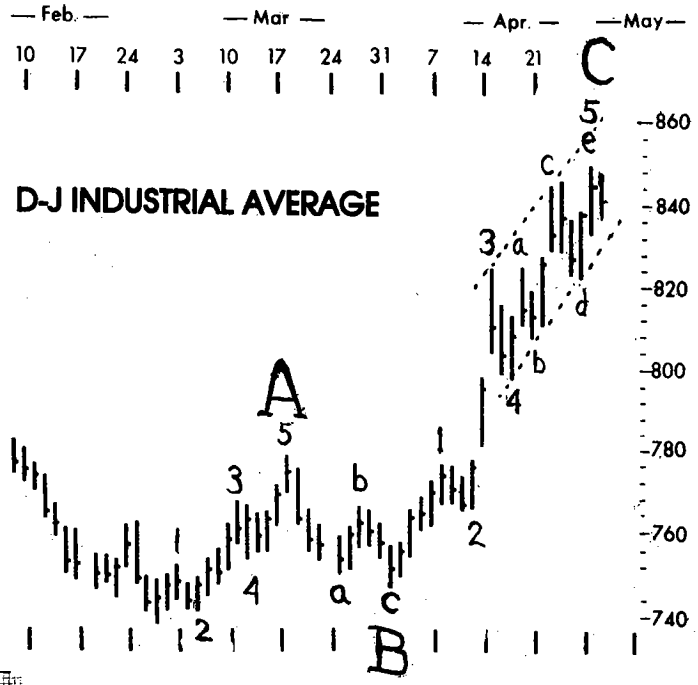
Since the end of leg C at 190, gold has corrected down to the 167-168 area. In doing so, gold broke just below the lower channel line. This is all right, and it served to turn about 3 out o

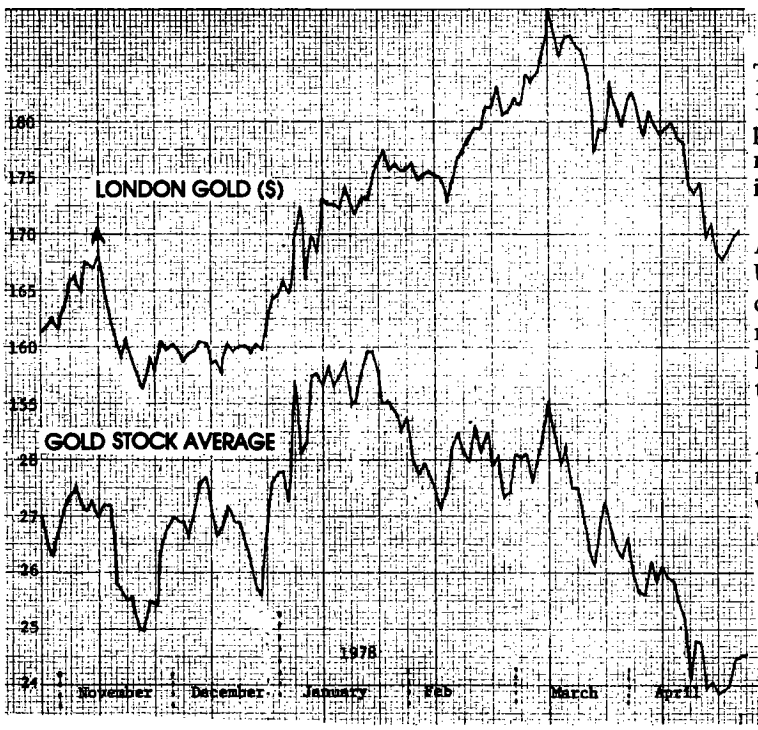
every 4 gold followers bearish. In my opinion, gold is now basing, and the 168 area could hold, or gold might even slide to even stronger support at 161-164.

On the very near term, my half-point (50 cent) P&F chart of bullion shows a little head-and-shoulders bottom which could prove interesting. If so, a price of 171 would be the first bullish signal. Hitting 171 gold could have a surprisingly strong rally, but I'm not convinced that we have seen enough of a base yet to take gold back to (and above) 190.

LATE MARKET NOTES: Speaking of Elliott, I now have what I believe is a completed Elliott "count" for the Dow on this bear market rally. In Letter 727 (page 6) I included a daily Dow chart and wrote as follows: "The market is going to do what it has to do to fulfill its 'pattern destiny'." I believe we are seeing an Elliott upward correction, a typical 5-3-5 pattern. . ."

Now refer to the Dow chart (top of this page). The first wave took the Dow up (in five little legs) to large A at 773.82 (Mar.20) Next we saw a little 3-leg decline (a-b-c) to large B on April 3.



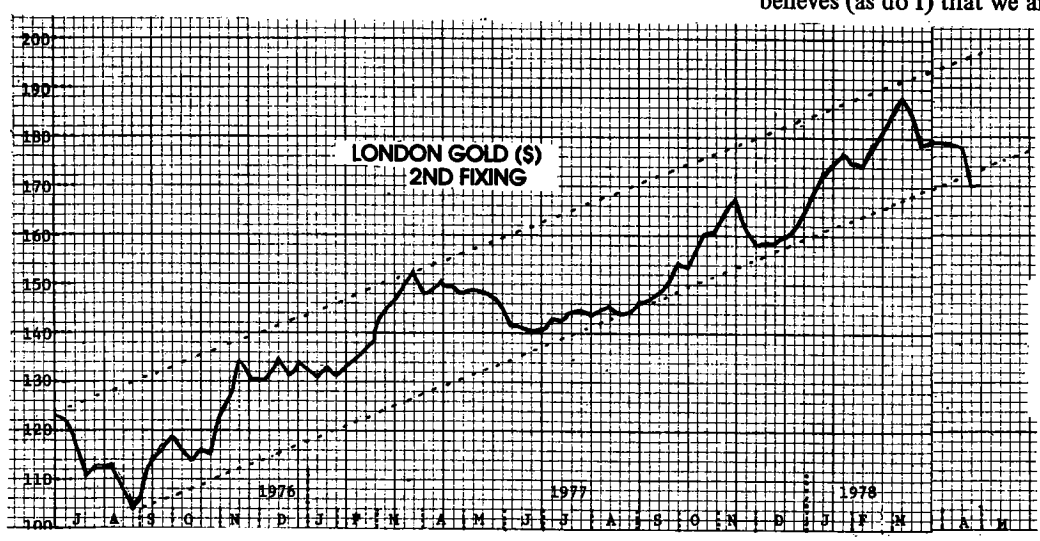


The leg to large C was a powerhouse. We saw an advance to point 1, then a little dip to point 2. A break-away "gap" exploded to point 3. Next we saw a 2-day decline to point 4. And most recently, we have seen wave 5 develop in a perfect channel as it sub-divided into an a-b-c-d-e.

At e (May 1) the large wave C should be just about completed. Unless the Dow can "extend" again, this time above the upper channel line (above 860-870), I would think the bear rally has run into exhaustion. The buyers should be about "used up." If so, then I would expect a move down towards or below 800, then another (but feebler) rally.

As an aside (and this isn't Elliott), the downside action of the market following abnormally high (in this case–record) volume could be on the dramatic side.

MORE: I just received the May *Bank Credit Analyst* (1245 Sherbrooke St. West, Montreal, Canada H3G1H2). Editor Boeckh sees "a resumption in the trend of liquidity deterioration as bank loans at all commercial banks rebounded sharply. . ." The BCA's monetary thermometer is still at a bearish plus 9 (a plus 8 or better is bearish). In short, I believe Editor Boeckh believes (as do I) that we are seeing a bear market rally.



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Spoke to Jim Blanchard and he says that tickets are moving fast for the Nassau Monetary Conference. Call Jim (504) 865-7561 if you want to know more about this June 1-4 conference.

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Ned Davis will appear on TV's "Wall Street Week" on May 12. Don't miss it. Ned is one of the best minds in the industry.

NEXT MAILING: May 17th